



# King County Investment Pool 2005 Annual Report

King County

Finance & Business Operations Division

Pool Report Website: <http://www.metrokc.gov/finance//treasury/KCInvestmentPool2005.pdf>

*Investment Pool is first in Washington State to receive highest credit rating from Standard and Poor's*

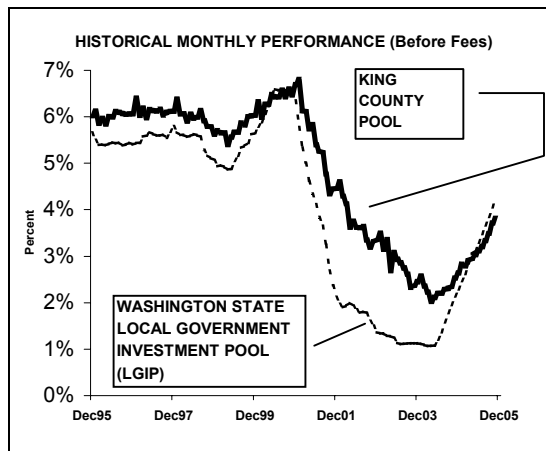
## ■ Pool Rating News

In 2005 the King County Investment Pool (the Pool) became the first local government investment pool in Washington State to be rated by Standard & Poor's Rating Services, receiving its highest credit rating of 'AAAF'. The 'AAAF' rating indicates that the Pool's security holdings provide extremely strong protection against losses from credit defaults and is the highest of the seven ratings, ranging from, 'AAAF' (highest level of protection) to 'CCCF' (least protection).

Standard & Poor's also recognized the Pool's conservative investment strategy and low-sensitivity to fluctuating market conditions by assigning the Pool an 'S1' volatility rating. Volatility ratings range from 'S1' for low sensitivity to changing market conditions, to 'S6' for highest volatility. In the process of assigning a 'S1' volatility rating to the Pool, Standard & Poor's analyzed the Pool's eligible portfolio investments and strategy, historical return volatility, and management.

Participants in a rated investment pool enjoy several important benefits: 1) Peace-of-mind from knowing that a reputable, third-party firm like Standard & Poor's is regularly reviewing the Pool's operations. 2) Communicating the risk-level of the Pool to taxpayers, commissioners, or board members should be improved since most people are familiar with the Standard and Poor's rating system. 3) Improved information for financial reports since Pool participants required by GASB 40 (Deposit and Investment Risk Disclosures) to report the credit quality of their investments can now state that their investment in the Pool is rated 'AAAF' instead of "unrated".

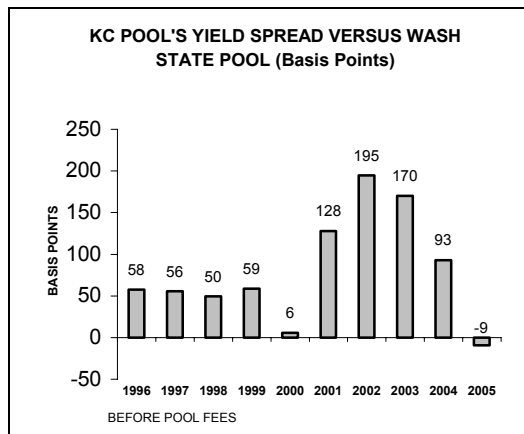
Information about Standard & Poor's fund rating criteria can be found at [www.standardandpoors.com](http://www.standardandpoors.com) under the "Funds" section. For questions about the Pool's rating, or GASB 40 disclosures, contact the Pool's Investment Officer, Mike Smith at 206-296-7311.



*"...the Pool's average distribution rate for 2005 was 3.15%; the Pool distributed about \$105 million to all its participants."*

## ■ 2005 Pool Performance

Our forecast in last year's report that the average earnings rate for 2005 would be "about 3%, and possibly somewhat higher" turned out to be on target: the Pool's average distribution rate for 2005 was 3.15%; the Pool distributed about \$105 million to all its participants. This was a healthy increase from 2004 when the distribution rate was 2.30% and \$78 million was paid out to participants.



The main reason for the increase in the Pool's distribution rate was the steady increase in short-term interest rates. With the economy expanding steadily, resource utilization increasing, inflationary pressures rising slightly, and short-



## King County Investment Pool

term interest rates still at stimulative levels, the Federal Open Market Committee (FOMC) continued to remove monetary policy accommodation by raising the federal funds rate from 2.25% at the beginning of the year, to 4.25% by the end of 2005.

***“...Pool participants earned about \$58,000 in additional revenue on each \$1 million they had invested with the Pool over the last five years.”***

While the yield on the Pool improved during the year, the Pool's performance when compared to Washington State Local Government Investment Pool (LGIP) was not as favorable as it has been in prior years. The reason for this was that short-term rates increased much faster than long-term rates during 2005. By year-end, short-term rates were almost higher than long-term rates—an unusual event that has only happened four times over the last 20 years.

By policy, the Pool has an average duration target that can range from about 1/2 a year to 1-1/2 years, while the LGIP's policy allows a maximum average duration of only 90 days, and generally their average days to maturity is in the 30 to 60 day range. During periods where short-term rates are rising over a prolonged period it is advantageous to have a very short duration because as the existing securities in the portfolio mature, they are reinvested at higher yields.

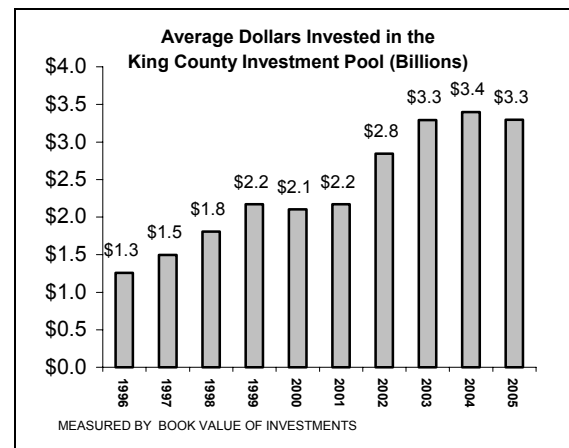
***“... all the districts that invest their funds are now Pool participants!”***

Fortunately, it is relatively rare for short-term interest rates to be at or above long-term rates, and over the long-run Pool participants have enjoyed higher earnings than if the Pool had a short-duration policy like the LGIP's. Over the last 5 years the Pool's gross yield has averaged 115 basis points (1.15%) more than the LGIP. In dollar terms, this means that Pool participants earned about \$58,000 in additional revenue on each \$1 million they had invested with the Pool over the last five years.

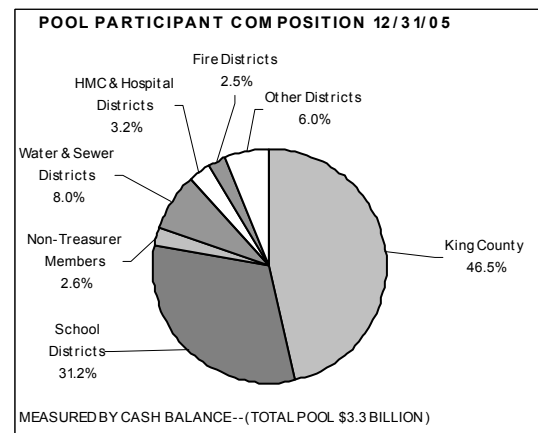
### ■ Pool Participation

The average amount invested in the Pool slightly decreased during 2005. The Pool's average asset base was \$3.3 billion, a small decrease from \$3.4 billion in 2004. At year-end, King County was the largest participant in the Pool, holding 46.5% of the Pool's assets. School districts were the second largest participant at 31.2%, followed by water and sewer districts at 8.0%.

One new member joined the Pool in 2005, bringing the total number of district and public authority participants to 99. With the addition of this member, all the districts that invest their funds are now Pool participants! We are very proud of this fact, and it is a major accomplishment since Pool participation has only been available to non-county entities since 1995. We are also very pleased that, other than by merger-activity, no district has ever terminated participation in the Pool.



We believe this loyalty to the Pool is due to the benefits it offers. By participating in the Pool, districts receive a competitive return from a diversified portfolio of high-quality investments. Participating in the Pool also eliminates the time that district personnel spend managing investment transactions and planning liquidity needs because their funds are 100% invested, while still having daily access to their cash when needed. For a list of all districts and public authorities participating in the Pool, please see page 7.

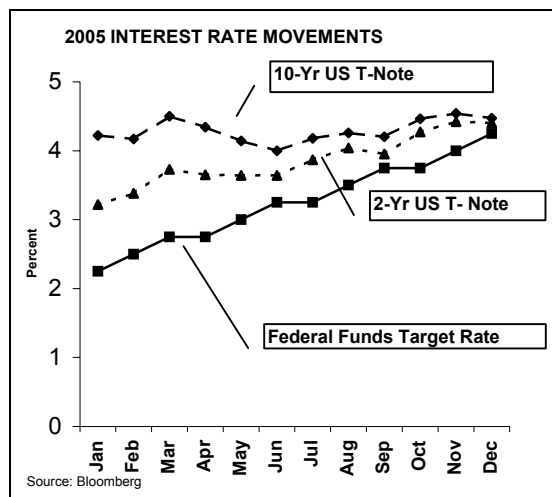




### ■ Review of 2005 Interest Rates

Since May of 2004 the FOMC had stated that it would remove policy accommodation by raising interest rates at a “measured” pace. The financial markets had interpreted this language to mean that the FOMC would raise rates by 25 basis points at every meeting and these rate increases would continue until they achieved their goal of a “neutral” rate—a rate that neither stimulated nor stifled economic growth. The financial markets were correct in their assessment. The FOMC raised the federal funds rate by 25 basis points at each of its meetings in 2005. By year-end, the federal funds rate was at 4.25%—an increase of 200 basis points from the start of the year.

Over the first half of 2005, short-term interest rates, like the 2-year Treasury note yield, increased in conjunction with the increase in the federal funds rate. However, longer rates, like the 10-year Treasury note yield, actually declined. This decrease in long-term rates while the FOMC was increasing the federal funds rate was a surprise to many, including FOMC Chairman Alan Greenspan, who spoke of the low-level of long-term rates as a “conundrum”.



At mid-year, economic reports began to come in stronger than many investors expected—especially in the real estate market. This caused 2-year and 10-year yields to increase since it appeared that the FOMC would continue to reduce the amount of monetary stimulus being supplied to the economy by continuing their gradual increase in the federal funds rate. However, the impact of the major hurricanes that struck in the late summer and fall—especially Hurricane Katrina—convinced many investors that the FOMC would not continue to raise rates. This caused 2-year and 10-year yields to decline for a time. Still, the economic damage caused by these major storms and the resulting

increase in the price of oil to over \$60 a barrel was not enough to significantly dampen the strength of the economy.

Concerned that the high cost of oil could kindle inflation if companies began to pass on higher fuel costs to their customers, and with the economy operating at a relatively high level of resource utilization, the FOMC continued to increase rates during the fourth quarter of the year. When it became apparent to the financial markets that the FOMC would continue to increase rates, 2 and 10-year yields resumed their upward trend.

### ■ Forecast for 2006 Performance

At their first meeting of 2006, the FOMC raised the federal funds rate another 25 basis points, bringing the rate to 4.50%. In addition to raising interest rates at their January meeting, they also modified the press release that accompanies their meetings. The “measured” pace language was dropped and replaced by the phrase “...some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance.” The financial markets interpreted this language to mean that the FOMC was thinking that it was getting close to its target of a “neutral” level of interest rates.

Many economists also believe that this change in language by the FOMC was a signal that further increases in the federal funds rate will be dependant on the future strength of the U.S. economy, and that the era of 25 basis point increases at every meeting is over. However, the recent retirement of Chairman Greenspan further complicates matters. Chairman Greenspan was at the helm of the FOMC for nearly 20 years. While his replacement, Ben Bernanke, says he intends to continue the policies of the Greenspan era, this change makes it even more difficult to forecast future FOMC actions.

Currently, economic conditions look fairly positive for the near future. The FOMC is forecasting that real Gross Domestic Product (GDP) will grow by 3-1/2% in 2006, that unemployment will be in the 4-3/4% to 5%, and that inflation, excluding food and energy costs, will be about 2%. This is a fairly optimistic forecast considering the economy must deal with the drag on growth caused by \$60 per barrel oil prices, and the related problem that high oil prices could also stimulate inflationary expectations.



OVERVIEW OF THE KING COUNTY POOL'S INVESTMENT POLICY				
Investment Types	Max Maturity	Max % Limit	Single Issuer Limit	Minimum Credit Rating
US Treasury	5 Years	100%	None	N/A
Federal Agency	5 Years	50%	50%	N/A
Fed Agency MBS	5 Year WAL	25%	25%	N/A
CD's	5 Years	15%	5%	PDPC <sup>(1)</sup>
Municipals <sup>(2)</sup>	5 Years	20%	5%	A <sup>(3)</sup>
Bank Notes	5 Years	20%	5%	A <sup>(3)</sup>
Repos	60 Days <sup>(4)</sup>	40%	10%	Collateral
Commercial Paper	180 Days	25%	5%	A1/P1 <sup>(5)</sup>
BA's	180 Days	25%	5%	Top 50 <sup>(6)</sup>
State LGIP <sup>(7)</sup>	N/A	None	None	N/A

<sup>(1)</sup> Institution must be a Washington State depository. Treasurers can deposit up to 100% of bank's net worth.  
<sup>(2)</sup> Washington state issuers: general obligations and revenue bonds. Other states: only general obligation bonds.  
<sup>(3)</sup> Must be rated "A" or better by two rating agencies.  
<sup>(4)</sup> 102% collateralized, over 30 days 105%  
<sup>(5)</sup> Must be rated in top credit category by at least two rating agencies. Maturities > 100 days must have "AA" long-term rating.  
<sup>(6)</sup> Bankers' acceptances can only be purchased from the 50 largest banks in the world by asset size.  
<sup>(7)</sup> The state investment pool (LGIP) is a money market-like fund managed by the State Treasurer's Office.

The financial markets are currently pricing in a federal funds rate of 5% by year-end 2006. A survey of 73 economists recently taken by Bloomberg News shows that their average forecast for the federal funds rate is also 5%, with the range of forecasts going from 4-1/4% to 5-3/4%. The FOMC has raised rates 350 basis points since it began raising rates in June 2004. If the financial markets and the economists are correct, they may have to only raise rates by another 50 basis points to conclude this cycle of rate increases.

**"...the average earnings rate for 2006 could be at least 4-1/4%, and possibly higher."**

If rates rise as expected over the remainder of the year, the Pool rate should continue to increase during 2006. The Pool's gross earnings rate has been approximately 4% for the first two months of 2006. At this time, we are estimating that the average earnings rate for 2006 could be at least 4-1/4%, and possibly higher. If the economy grows faster than expected and the FOMC needs to raise rates in line with the more aggressive rate forecasts, the Pool's gross rate could average closer to 4-3/4% for the year.

## Pool Organization

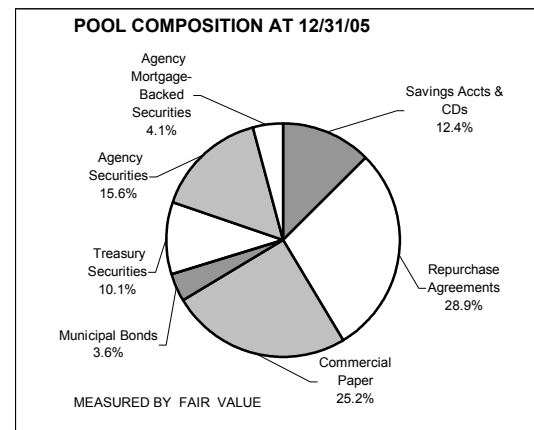
In accordance with Washington State code (RCW 36.48.070), the County's Executive Finance Committee (the EFC) reviews the Pool's investment practices and policies on a regular basis. The Committee consists of the Chair of the County Council, the County Executive, the Chief Budget Officer, and the Manager of the Finance and Business Operations Division (or their designees). All investment activity is subject to written policies approved by the EFC. The Committee monitors pool performance at its monthly meetings. Responsibility for managing the Pool's investments on a daily basis lies within

the Cash Management Unit of the County's Treasury Operations Section.

## Review of Pool Investment Practices

**Diversification:** The Pool pursues its investment objectives by investing in high-quality securities, including U.S. Treasury, U.S. agency notes and mortgage-backed securities, taxable-municipal notes, commercial paper, certificates of deposits (CDs), repurchase agreements, and the LGIP.

The Pool has policies that limit the maximum amount that can be invested in any one of these sectors. The table above summarizes the Pool's diversification policy, while the following pie chart shows the Pool's actual composition at year-end.



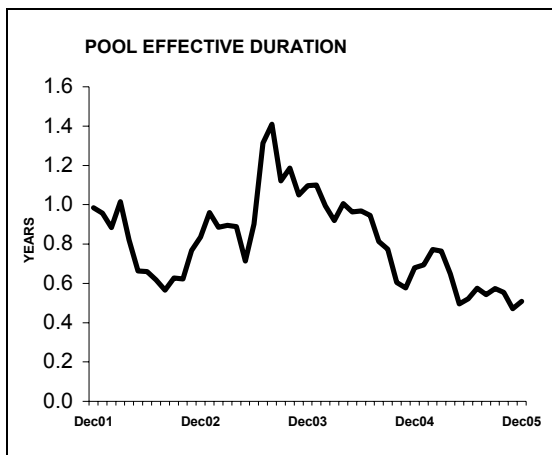
**Market Risk:** The Pool limits its exposure to changes in interest rates by managing the effective duration of the Pool. Duration is a measure of a portfolio's sensitivity to changes in interest rates. Portfolios with lower durations are less sensitive to changes in interest rates than portfolios with higher durations. For example, if the yield curve instantaneously shifts by 100



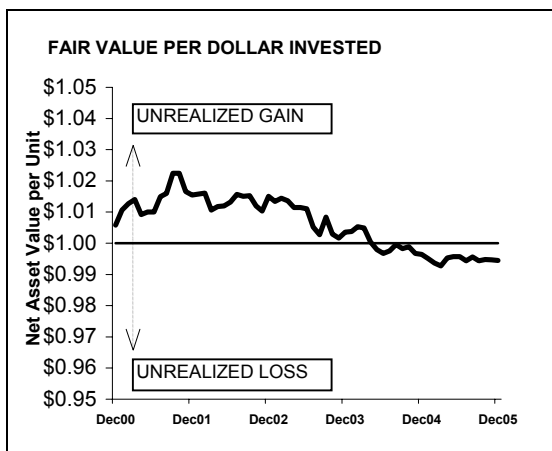
## King County Investment Pool

basis points, the market value of a portfolio with a duration of one year will change by approximately 1%. However, a portfolio with a duration of 10 years would see its market value change by about 10%.

Ideally, the Pool wants to have a longer duration when rates are falling and a shorter duration when rates are rising. At year-end, the Pool's combined effective duration was about 0.5 years. Over the prior ten years the Pool's duration has averaged 1.1 years and has ranged from 0.5 to 1.8 years.



The Pool is managed as two sub-portfolios: the Core portfolio consists of long-term securities with maturities over one year; the Liquidity portfolio consists of securities with a shorter maturity. The average effective duration of the Core portfolio is limited to a range between 1.25 to 3.25 years. Securities purchased in the Core portfolio must have a final maturity no longer than five years. The maximum average duration of the Liquidity portfolio is limited to 120 days.

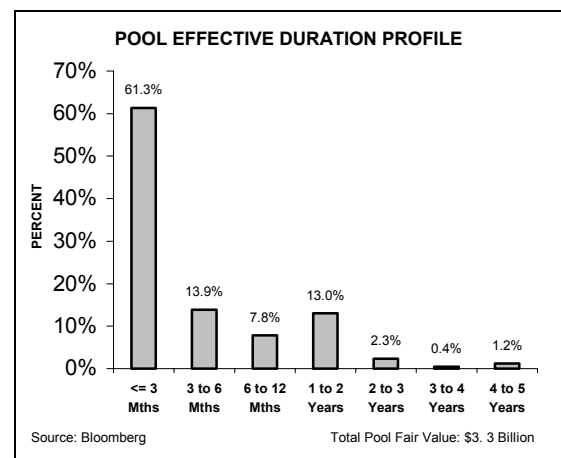


The Pool's duration and maturity policies help to reduce the variation in the Pool's net asset value. At year-end each \$1 invested in the Pool had a value of \$0.9945. The stability of the Pool's net

asset value is demonstrated by the low volatility of the Pool's fair value. Over the last six years the fair value per dollar invested has fluctuated between \$0.99 and \$1.02.

Although the Pool's fair value is calculated on a monthly basis, unrealized gains and losses are not distributed to participants. The Pool distributes earnings using an amortized cost methodology.

**Liquidity:** The Pool's policy is to maintain sufficient liquidity to meet all anticipated operating requirements. Historical cash flows are used in combination with projected debt service schedules to insure that the Pool has adequate liquidity to meet all Pool participants' projected needs. At year-end, the Pool had a healthy liquidity position with approximately 61% of the portfolio expected to come due in three months or less.



**Credit Quality:** The Pool has about 28% of its portfolio invested in 'AAA' quality U.S. Treasury, agency, and municipal securities. Almost 58% of the Pool's investments are invested in securities or placed with counterparties that have a short-term rating of at least 'A-1', or its equivalent, which is one of the top ratings for short-term securities.

A Nationally Recognized Statistical Rating Organization (NRSRO) such as S&P does not rate about 12% percent of the portfolio's securities. These non-rated investments are composed of CDs and the Pool's investment in the State's LGIP. While this group of investments is not rated by an NRSRO, they are still very safe investments.

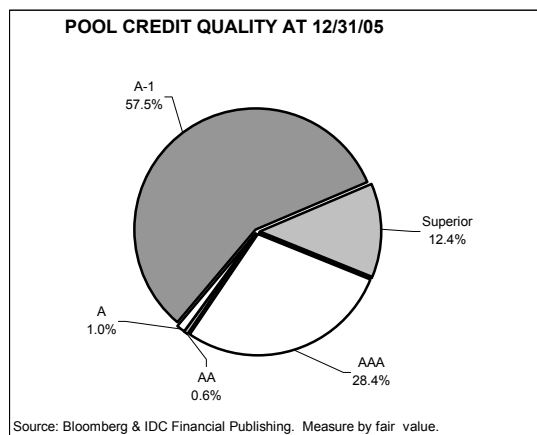
CDs are placed only with depositories that are approved by the Public Deposit Protection



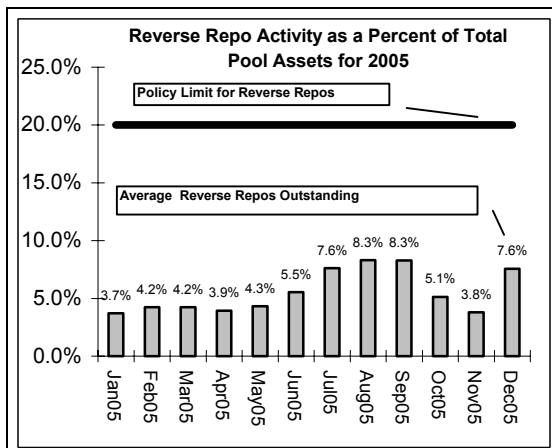
## King County Investment Pool

***“The Pool generated nearly \$433,000 in additional income in 2005 from reverse repurchase activity.”***

Commission (PDPC). The PDPC provides security for public treasurers by protecting public deposits that exceed the amount insured by the FDIC. No public funds placed in public depositories have been lost since the Public Deposit Protection Act (RCW 39.58) was created in 1969. As additional protection, the Pool pays for a service provided by IDC Financial Publishing that monitors the financial condition of these non-rated institutions. At year-end, all issuers of CDs were rated “Superior” by IDC.

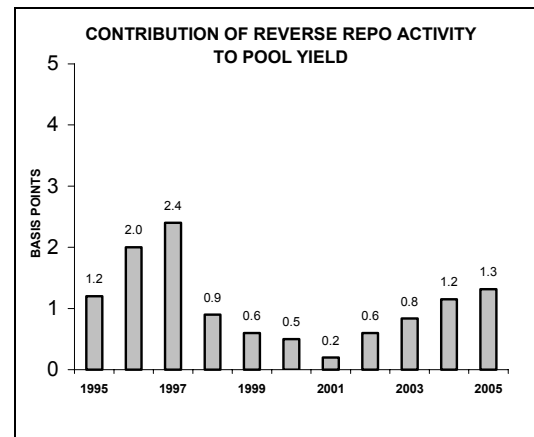


**Leverage:** The Pool is authorized to use reverse repurchase agreements. In a reverse repurchase transaction the Pool borrows funds from an approved dealer by pledging securities in its portfolio. It then uses the proceeds of the borrowing to invest in securities that yield more than the borrowing rate. This type of arbitrage transaction generates extra income for the Pool while exposing the Pool to very little risk.



The Pool can only enter into reverse repurchase agreements under the following conservative guidelines:

- No more than 20 percent of the Pool balance may be reversed out at one time.
- The maturity date of the reverse repurchase must equal the maturity date of the investment.
- The maximum allowable maturity is 180 days.
- Reverses will only be entered into with dealers having a master repurchase agreement with King County.



During 2005, total reverse repurchase agreements outstanding at month-end ranged from 3.7% to 8.3% of the portfolio’s total assets—never approaching the 20% policy limit. The Pool generated nearly \$433,000 in additional income in 2005 from reverse repurchase activity. This added 1.3 basis points to the Pool’s overall yield during 2005. Ω

***For further information or questions regarding King County’s Investment Pool, please contact the following individuals:***

**Mike Smith, CFA**

Investment Officer: 206-296-7311 or [Mike.Smith@Metrokc.gov](mailto:Mike.Smith@Metrokc.gov)

**Scott Matheson**

Cash Mgmt Supervisor: 206-296-7313 or [Scott.Matheson@Metrokc.gov](mailto:Scott.Matheson@Metrokc.gov)



## KING COUNTY INVESTMENT POOL PARTICIPANTS

<p><b><u>King County</u></b> All Agencies</p> <p><b><u>School Districts</u></b> Auburn SD No. 408 Bellevue SD No. 405 Enumclaw SD No. 216 Federal Way SD No. 210 Issaquah SD No. 411 Highline SD No. 401 Kent SD No. 415 Lake Washington SD No. 414 Mercer Island SD No. 400 Northshore SD No. 417 Puget Sound ESD No. 121 Riverview SD No. 407 Renton SD No. 403 Seattle SD No. 1 Shoreline SD No. 412 Skykomish SD No. 404 Snoqualmie Valley SD No. 410 Tahoma SD No. 409 Tukwila SD No. 406 Vashon Island SD No. 402</p> <p><i>* Districts joining in 2005</i></p>	<p><b><u>Fire Districts</u></b> Black Diamond Fire District No. 17 Burien Fire District No. 2 Eastside Fire &amp; Rescue No. 10 &amp; 110 Federal Way Fire Department No. 39 KC Fire District No. 20 KC Fire District No. 24 KC Fire District No. 25 KC Fire District No. 26 KC Fire District No. 27 KC Fire District No. 28 KC Fire District No. 34 KC Fire District No. 37 KC Fire District No. 40 KC Fire District No. 41 KC Fire District No. 43 KC Fire District No. 45 KC Fire District No. 47 KC Fire District No. 50 Mountain View Fire &amp; Rescue No. 44 North Highline Fire District No. 11 Northshore Fire Department No. 16 Shoreline Fire Department No. 4 Vashon Island Fire &amp; Rescue No. 13 Woodinville Fire Life &amp; Safety No. 36</p>	<p><b><u>Sewer &amp; Water Districts</u></b> Bryn Mawr-Lakeridge Sewer District Cedar River District No. 108 Coal Creek Utility Covington Water District No. 105 Highlands Sewer District Highline Water District No. 75 KC Water District No. 1 KC Water District No. 20 KC Water District No. 45 KC Water District No. 49 KC Water District No. 54 KC Water District No. 83 KC Water District No. 90 KC Water District No. 111 KC Water District No. 117 KC Water District No. 119 KC Water District No. 123 KC Water District No. 125 KC Water District No. 127 Lakehaven Utility Midway Sewer District Northeast Sammamish Sewer District Northshore Utilities Ronald Wastewater Mgmt District Sammamish Plateau Sewer District Shoreline Water District No. 42 Soos Creek Sewer District Southwest Suburban Sewer District Stevens Pass Sewer District Val-View Sewer District Vashon Sewer District Vashon Water District No. 19 Woodinville Water District No. 104</p>	<p><b><u>Other Districts</u></b> Cemetery District No. 1 Drainage District No. 1 Finn Hill Park District King County Director's Association King County Law Library King County Library Northshore Parks and Recreation Public Facilities District (Baseball) Puget Sound Air Pollution Control Puget Sound Regional Council Redmond Library Capital Facility Si View Metropolitan Park District Vashon Park District* Washington State Risk Pool</p> <p><b><u>HMC &amp; Hospital Districts</u></b> Harborview Medical Center Snoqualmie Valley Hospital No. 4</p> <p><b><u>Non-Treasurer Members</u></b> Evergreen Healthcare (Hospital Dist. 2) Public Stadium Authority (Football) Puget Sound Regional Transit Authority Water &amp; Sewer Risk Management Pool Valley Medical (Hospital Dist. 1)</p>
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**King County Executive Ron Sims**  
**King County Council Chairman Larry Phillips**

**KING COUNTY**  
**EXECUTIVE FINANCE COMMITTEE**

**Dow Constantine, Councilmember, Chair EFC**  
**Paul Tanaka, County Administrative Officer**  
**Ken Guy, Finance Director**  
**Bob Cowan, Budget Director**

**Committee Staff**  
Phil Sanders, Interim Treasury Operations Manager  
Scott Matheson, Cash Management Supervisor  
Mike Smith, CFA, Investment Officer

*For further information or questions regarding King County's Investment Pool, please contact Mike Smith at 206-296-7311 or [Mike.Smith@Metrokc.gov](mailto:Mike.Smith@Metrokc.gov)*